FILED
AUG 6 - 2007

(4) (5) (5) (3)

Nos. 06-1454, 06-1457, 06-1462, and 06-1468

# In the Supreme Court of the United States

SEMPRA GENERATION, *et al.*, and
DYNEGY POWER MARKETING, INC., *et al.*,

*Petitioners*

v.

PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA, *et al.*,

*Respondents*

MORGAN STANLEY CAPITAL GROUP INC. and
CALPINE ENERGY SERVICES, L.P., *et al.*,

*Petitioners*

v.

PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY
WASHINGTON, *et al.*, and
FEDERAL ENERGY REGULATORY COMMISSION,

*Respondents*

**On Petitions for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit**

## BRIEF OF THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., AND THE FINANCIAL INSTITUTIONS ENERGY GROUP AS *AMICI CURIAE* SUPPORTING PETITIONERS

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## BRIEF OF THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., AND THE FINANCIAL INSTITUTIONS ENERGY GROUP AS *AMICI CURIAE* SUPPORTING PETITIONERS

### INTEREST OF THE *AMICI CURIAE*[1]

The International Swaps and Derivatives Association, Inc. (ISDA), is the largest financial trade association in the world, representing leading participants in the privately negotiated derivatives industry. It was chartered in 1985, and includes more than 780 member institutions from 54 countries on six continents. These members include most of the world's major institutions that deal in, and are leading end users of, privately negotiated derivatives, as well as many of the businesses, governmental entities, and other end users that rely on derivatives to manage efficiently the financial market risks inherent in their core economic activities. Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business.

The Financial Institutions Energy Group (FIEG) is a group of investment and commercial banks and other financial institutions, all of which play a vital role in the electric utility industry. The businesses of FIEG members (and their affiliates) as they relate to the energy sector are very diverse. They are directly involved in the purchase and sale of electric energy, capacity, and ancillary services, and many are power marketers with market-based rate authority. They are also involved in a wide array of other businesses that are only incidentally related to the electric industry. For example, FIEG members may act as market-making dealers, participants in physically and financial-

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[1] The parties' letters of consent to the filing of this brief have been lodged with the Clerk. Pursuant to Rule 37.6 of the Rules of this Court, *amici curiae* state that no counsel for a party has written this brief in whole or in part and that no person or entity other than the *amici curiae*, their members, or their counsel has made a monetary contribution to the preparation or submission of this brief.

ly settled derivative transactions designed to hedge certain counterparty risk or to establish a proprietary position in the market, arrangers of loan facilities, and underwriters of debt and equity securities.

Members of ISDA and FIEG are substantial participants in the market for wholesale electric power sales. Some of those members own interests in companies that produce electric power and sell it in the wholesale market. Some own interests in companies that purchase electric power in the wholesale market and distribute it to end users. And some are not involved in either the production or the retail distribution of electric power, but participate as traders that buy and sell power in transactions with producers, retail distributors, and other traders. ISDA and FIEG do not have an institutional interest to promote legal rules that systematically favor either buyers or sellers of electric power. Rather, *amici* seek to promote legal rules necessary to ensure a vibrant and efficient *market* for electric power, which will benefit all market participants – both buyers and sellers – and, indirectly, end users of electricity, whose interests are served by the efficient production and distribution of electric power.

This interest in a vibrant and efficient market is threatened by the Ninth Circuit's decisions in these cases. Clear, stable, and enforceable rules governing contracts are essential for any market to function effectively, and are especially important in the market for electric power, which depends on long-term investments and contractual sales involving hundreds of billions of dollars every year. For more than half a century, decisions of this Court have protected the legitimate economic expectations of participants in this market, by making clear that, when parties choose to enter into a contract to buy or sell power, their agreement will be enforced even if, in hindsight, the agreement turned out to be unfavorable to one or more contracting parties. The Ninth Circuit's decisions are fundamentally at odds with that principle. Because of their members' unique role in this market, *amici* are well positioned to explain why the Ninth Circuit's decisions, if allowed to stand, will lead to market dys-

function that will impose enormous costs on the American public.

## SUMMARY OF ARGUMENT

Unless corrected, the Ninth Circuit's decisions will cause serious harm to the market for wholesale electric power. That market is extraordinarily important to the Nation's economy. End users spend about $300 billion annually to purchase electricity, and much of that power is purchased in a vibrant wholesale market that has developed over the past decade. In addition to producers and retail distributors of power, participants in this wholesale market include many firms that principally operate as traders. Their presence has enhanced market liquidity and transparency, and has permitted producers and distributors to reduce their exposure to financial risk by using contractual arrangements that shift risk to traders with greater expertise in risk management.

It is essential for those traders, and for other market participants, to be able to rely on the integrity and enforceability of contracts. That need has been served for more than half a century by the *Mobile-Sierra* doctrine, which prevents the regulatory abrogation of contracts in all but the most extraordinary circumstances. The Ninth Circuit's decisions, while purporting to apply that doctrine, effectively overrule it.

The Ninth Circuit held that the *Mobile-Sierra* doctrine cannot be invoked unless the Federal Energy Regulatory Commission (FERC) had an initial opportunity to conduct a plenary "just and reasonable" review of contract rates and to review the market conditions under which the contract was negotiated – and to conduct such a review not just when the contract is executed, but years later, with the benefit of hindsight. The Ninth Circuit then held that buyers may escape their contractual obligations and obtain rate reductions if, in retrospect, their contract was negotiated in a "dysfunctional" market and established rates that proved to be outside a zone of reasonableness. These standards dramatically undermine sellers' ability to rely on buyers' contractual commitments.

Only this Court can prevent the harm threatened by the Ninth Circuit's errors. For so long as the decisions remain on the books as valid precedents, they create a risk that buyers will be able to escape their contractual commitments – if not these commitments by these buyers, perhaps other commitments by other buyers in the future. Regardless of FERC's eventual decisions about the specific contracts involved here, that risk will remain. Among other things, the Ninth Circuit's new standards will discourage the use of long-term contracts that provide important benefits – facilitating investment, mitigating financial risks, and reducing market volatility. Those standards will also discourage sellers of power from increasing supply when it is most needed, *i.e.*, when prices spike upwards in response to a large imbalance between demand and supply. That is the circumstance in which sellers will least be able to rely on buyers' contractual commitments, because that circumstance is most likely to be characterized, in retrospect, as a market "dysfunction." The standards will vastly increase the likelihood and the cost of litigation, because the enforceability of contracts will no longer depend on the straightforward question whether a contract is valid but will rest, instead, on the amorphous question whether the market was "dysfunctional." In these and other respects, the Ninth Circuit's decisions, unless corrected, will raise the costs and reduce the financial rewards to companies that produce electric power and trade in the wholesale power market. Regardless of the outcome of the specific disputes in these cases, the Ninth Circuit decisions threaten serious harm to the efficient operation of that market and, ultimately, to consumers.

## ARGUMENT

### I. Unless Corrected, The Ninth Circuit's Interference With The Enforcement Of Contracts Will Undermine An Extraordinarily Important Sector Of The Economy

The electric power industry affects daily life and the Nation's economic well-being to a degree that is matched by few other industries. End users spend about $300 billion annually to

purchase electricity in the United States.[2] Electric power is essential to virtually every productive activity in the Nation's economy, and the generation and consumption of electricity is strongly correlated with the overall level of economic activity.[3]

Today, companies that distribute electricity to end users buy the overwhelming proportion of that power in wholesale transactions. This fact reflects fundamental changes in the regulation and structure of the industry over the past decade. For most of the twentieth century, the industry was dominated by vertically integrated utilities that generated electricity, transmitted it to local distribution networks, and provided retail service to end users, subject to cost-based rate regulation. Beginning in the mid-1990s, FERC (regulating wholesale power sales) and many States (regulating retail sales) shifted from cost-based rate regulation to a market-based regime. To ensure competition in wholesale sales, high-voltage transmission lines (which carry electricity from the point of generation to local distribution networks) were subjected to "open access" requirements, permitting many different producers of power to compete to sell power to individual retail distribution companies. In addition, many vertically integrated utilities were divided into separate generation and distribution companies. See generally 06-1457 Pet. App. 11a-22a.

The result of these changes was "a sharp increase in wholesale power sales – subject to FERC's exclusive jurisdiction – as utilities shopped among suppliers." 06-1457 Pet. App. 21a. "[T]he breakup of vertically integrated utilities created the need for many more wholesale transactions." *Ibid.* Three trillion 661 billion kilowatt-hours of electricity were sold at retail in 2005;

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[2] Energy Information Administration, *Revenue from Retail Sales of Electricity To Ultimate Customers by Sector, by Provider* (Oct. 4, 2006), available at http://www.eia.doe.gov/cneaf/electricity/epa/epat7p3.html.

[3] Edison Electric Institute, *U.S. Economic Growth Is Linked To Electricity Growth* (2007), available at http://www.eei.org/industry_issues/industry_overview_and_statistics/realgdp.pdf.

nearly 90% of that amount (3,246 billion kilowatt-hours) was purchased by the companies engaged in retail distribution.[4]

The wholesale market that has developed is broad, diverse, complex, and very, very large. Power is sold in many different ways. Some sales result from bilateral negotiations between individual buyers and sellers; some are effected through a competitive bidding process; some are conducted on organized exchanges. Power is sold in spot markets, in which buyers can acquire power to supply immediate, short-term needs. It is also sold through contracts that provide for the delivery of power over longer time periods, sometimes covering many years.

Participation in the wholesale market has expanded far beyond those companies that produce or distribute electric power. The roster of electric power marketers now includes many large traders, including members of ISDA and FIEG. Some of these firms own interests in power producers and/or distributors; some do not. Regardless, the principal market activity of many of these traders (including those that own interests in producers or distribution businesses and those that do not) consists of contracting with power producers, distribution companies, and other traders to buy or sell wholesale power that will ultimately be produced or distributed by others.

In an important way, the firms that participate in the market principally as traders are unlike power producers selling their own output, or distribution companies purchasing power for resale to end users. Traders tend, over the long term, to be neither net sellers nor net purchasers of power. Traders generally seek to purchase only the power they can sell, and to sell only what they can purchase. Thus, they have no vested interest in rules that systematically favor sellers or buyers. Their interest, instead, is in rules that enhance the efficient operation of the market, for the benefit of both buyers and sellers.

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[4] *Electric Power Annual*, Energy Information Administration (Nov. 9, 2006), available at http://www.eia.doe.gov/cneaf/electricity/epa/epasum.html.

These firms play an extremely important role in wholesale power markets. Their expertise and their extensive trading operations allow them to mitigate financial risks. For example, by assembling a diverse portfolio of contractual obligations to buy and sell power at different times and at different prices, these firms can insulate themselves from many of the risks of temporary price volatility as well as longer term unfavorable price trends. Perhaps more important, by contracting with producers and distributors of power, these firms allow the producers and distributors to avoid those risks. A simple, classic example is a retail distributor that chooses to enter into a long-term contract to purchase power at a fixed price. The contract assures the buyer a stable supply of power at a guaranteed price. The risk that prices will rise over the duration of the contract is transferred to the seller, which may be better positioned to mitigate that risk through its extensive trading operations and its expertise in managing financial risk.

A vibrant and efficient market for wholesale power sales provides other important benefits. The market – especially because of the participation of large traders – enhances liquidity in the sale of electric power, so that buyers can readily find sources of supply and sellers can readily find buyers for power. In addition, a well-functioning market enhances the transparency and efficiency of prices, both short term and long term, thereby enabling buyers and sellers to respond more rapidly and efficiently to changing market conditions.[5]

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[5] For recent empirical studies confirming the benefits of broad trader participation in energy markets, see Michael S. Haigh, Jeffrey H. Harris, James A. Overdahl & Michael A. Robe, *Market Growth, Trader Participation and Pricing in Energy Futures Markets* (Feb. 7, 2007), available at http://web.uvic.ca/econ/robe.pdf; Michael S. Haigh, Jana Hranaiova & James A. Overdahl, *Price Dynamics, Price Discovery and Large Futures Trader Interactions in the Energy Complex* (April 28, 2005), available at http://cftc.gov/files/opa/press05/opacftc-managed-money-trader-study.pdf.

To function effectively, the wholesale power market *requires* clear and enforceable contract rights. Such rights are especially important to ensure broad participation in the market by firms other than producers and distributors of power. Producers and distributors, if they wish to remain in business, must sell and buy power. But firms that function principally as traders have choices about the extent to which they will participate in this market. A regulatory environment that impedes their ability to manage risk, by creating uncertainty about contract enforcement, will encourage them to commit their capital to other markets that entail less risk. If that is allowed to happen, the cost to the electric power industry, and to the public (which depends on that industry daily), will be very large. As we explain below, unless reversed, the Ninth Circuit's repudiation of long-settled principles that protected the enforceability of contracts in this market will have that deleterious effect.

## II. The Ninth Circuit's Decisions Will Undermine Contractual Expectations That Have Been Protected For More Than Fifty Years By The *Mobile-Sierra* Doctrine

### A. The *Mobile-Sierra* Doctrine Has Protected The Integrity Of Contracts For Both Buyers and Sellers, Because Doing So Serves The *Public's* Interests

For more than half a century, long-term contracts for wholesale electric power sales have been negotiated with the understanding that such contracts could be enforced, pursuant to the *Mobile-Sierra* doctrine, even if changes in the marketplace rendered the contract unprofitable for one of the parties.

In *United Gas Pipe Line Co.* v. *Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956), this Court held, unanimously, that a natural gas company could not unilaterally modify a contractual rate by filing a new rate with the Federal Power Commission. Notwithstanding requirements in the Natural Gas Act that all rates must be just and reasonable, the Act "expressly recognizes that rates to particular customers may be set by individual contracts" and "evinces no purpose to abrogate private rate contracts." *Id.* at 338. That conclusion was compelled by the terms of the Act and

promoted the Act's purposes, as well. "[P]reserving the integrity of contracts * * * permits the stability of supply arrangements which all agree is essential." *Id.* at 344. Parties could not be expected to make "substantial investments * * * without long-term commitments," and such commitments are impossible if "supply contracts are subject to unilateral change." *Ibid.*

The Court followed and extended the *Mobile* decision in another unanimous decision on the same day. *Federal Power Comm'n* v. *Sierra Pacific Power Co.*, 350 U.S. 348 (1956), arose under the Federal Power Act, the relevant provisions of which were "substantially identical" to the provisions of the Natural Gas Act that were construed in *Mobile*. *Id.* at 353. *Sierra* followed *Mobile* in holding that a party could not unilaterally modify the rate established in a long-term contract by filing new rates with the Commission. *Sierra* also addressed a question not presented in *Mobile*: In what circumstances could the Commission determine that contract rates were unlawful, and prescribe modifications to those rates to remedy the perceived unlawfulness? *Sierra* held that the contractual rate could be set aside only if it would "adversely affect the public interest – as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." *Id.* at 355. This "public interest" standard is not satisfied merely because the rate prescribed by the contract was a rate that the Commission, itself, could not have imposed under a "just and reasonable" standard. "[W]hile it may be that the Commission may not normally impose upon a public utility a rate which would produce less than a fair return, it does not follow that the public utility may not itself agree by contract to a rate affording less than a fair return or that, if it does so, it is entitled to be relieved of its improvident bargain." *Ibid.* "[A] contract may not be said to be either 'unjust' or 'unreasonable' simply because it is unprofitable to the public utility." *Ibid.* In 2002, the Court explained, again, one of the reasons for that conclusion. "In wholesale markets, the party charging the rate and the party charged were often sophisticated businesses enjoying presumptively equal

bargaining power, who could be expected to negotiate a 'just and reasonable' rate as between the two of them." *Verizon Communications, Inc.* v. *FCC*, 535 U.S. 467, 479 (2002).

*Mobile* and *Sierra* involved efforts by sellers to increase rates charged to buyers, but subsequent decisions have confirmed that the decisive principle is that contracts must be enforced, not that the financial interests of buyers take precedence over the financial interests of sellers. *United Gas Pipe Line Co.* v. *Memphis Light, Gas & Water Division*, 358 U.S. 103 (1958), held that a seller could unilaterally raise contractual rates by filing the new rates with the Commission, when the contract permitted the seller to do so. "The important and indeed decisive difference between this case and *Mobile* is that in *Mobile* one party to a contract was asserting * * * the right unilaterally to abrogate its contractual undertaking, whereas here petitioner seeks simply to assert * * * rights expressly reserved to it by contract." *Id.* at 112. *Mobile*, *Sierra*, and *Memphis* gave buyers and sellers an option. They could contract for rates that could be set aside only in extraordinary circumstances or, if they preferred, they could contract for rates that could be modified unilaterally (as in *Memphis*), subject to Commission review under the traditional "just and reasonable" standard.

*Memphis* explained that the integrity of such contracts must be protected, not just to benefit the businesses that entered into those contracts, but to benefit the consuming public. The Court explained that enforcing contractual rights would protect "the legitimate interests of natural gas companies in whose financial stability *the gas-consuming public has a vital stake.*" 358 U.S. at 113 (emphasis added). Without legal protection of producers' contract rights, "the maintenance and expansion of their systems through equity and debt financing would become most difficult, if not impossible." *Ibid.*

In conflict with the Ninth Circuit, other courts of appeals have recognized that the *Mobile-Sierra* doctrine applies even-handedly to hold buyers to their commitments, even if they have agreed to rates that turned out to be "too high," just as it holds

sellers to their commitments when they have agreed to rates that turned out to be "too low." *Boston Edison Co.* v. *FERC*, 233 F.3d 60 (1st Cir. 2000); *Potomac Elec. Power Co.* v. *FERC*, 210 F.3d 403 (D.C. Cir. 2000).

As Judge Boudin has observed for a unanimous First Circuit panel, "[t]he *Mobile-Sierra* doctrine has hung over the electric power and natural gas industries since 1956, and the two cases are probably among the dozen best-known public utility decisions by the Supreme Court in this century." *Boston Edison*, 233 F.3d at 66. The integrity of contracts was a bedrock principle of the regulation of these industries, even under the old regulatory regime in which producers' costs provided the basis for determining just and reasonable rates in most cases. As FERC has recognized, under today's regulatory regime, in which just and reasonable rates are determined principally by private contractual arrangements that are subject to market forces, "[p]reservation of contracts has, if anything, become even more critical." 06-1457 Pet. App. 147a-148a.

### B. The Ninth Circuit's Decisions Undermine The Integrity Of Contracts By Dramatically Enhancing Buyers' Ability To Escape Contractual Obligations

Unless they are reversed, the Ninth Circuit's decisions in these cases will have the practical effect of overruling *Mobile* and *Sierra*. The court of appeals' standards for deciding *whether* to apply *Mobile-Sierra* principles to the review of contractual rates, and *how* to apply those principles, pose a large-scale threat to sellers' ability to hold buyers to their contractual commitments.

The Ninth Circuit held that *Mobile-Sierra* principles do not protect contract rates unless the Commission has an opportunity to conduct a "plenary, 'just and reasonable'" review of the rates at the outset of the contract. 06-1457 Pet. App. 41a. To permit that initial review, of course, would require filing the contract rate with FERC, a filing that FERC's rules do not otherwise require. But an opportunity to review the rates is not enough, according to the Ninth Circuit. In addition, the scope of FERC's

review must permit consideration of the "propriety of the contract's formation," including whether the contract negotiations "occurred in a functional marketplace." *Ibid.* And, even if contract rates are subject to that initial review, there is still no guarantee that the rates will be protected by the *Mobile-Sierra* doctrine if challenged at some later time. The Ninth Circuit explicitly held that *Mobile-Sierra* did not require enforcement of one of the contracts involved here because, when the contract was negotiated and filed with the Commission, "the full scale of * * * market dysfunction was not nearly as fully known as it is today." 06-1454 Pet. App. 11a. It held, furthermore, that buyers could seek unilateral modifications to rates even if their contract waived the right to do so. 06-1457 Pet. App. 42a-46a.

After creating those prerequisites for the application of *Mobile-Sierra* principles, the Ninth Circuit then gutted the content of those principles. It held that sellers' ability to escape contractual obligations continues to be governed by the *Sierra* standard – whether the contract will "adversely affect the public interest – as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." 350 U.S. at 355. Buyers, are the other hand, can escape contractual obligations "if a challenged contract imposes any significant cost on ultimate customers because of a wholesale rate too high to be within a zone of reasonableness." 06-1457 Pet. App. 63a. The standard, in other words, is whether the electric bills of consumers would be "higher than they would otherwise have been had the challenged contracts called for rates within the just and reasonable range." *Id.* at 64a.

These newly created standards drastically undermine sellers' ability to rely on buyers' contractual commitments. The standards make it impossible for sellers to control or confidently predict whether a contract will be enforceable, because a contract may be set aside for reasons entirely unrelated to the behavior of the contracting parties. Here, for example, there is no evidence that petitioners engaged in any market manipulation

that affected the contracts. See, *e.g.*, 06-1454 Pet. App. 118a. Similarly, there is no evidence of unfairness, bad faith, or duress by petitioners in the contract negotiations. 06-1457 Pet. App. 33a. And there is no evidence that any of these petitioners had, or exercised, market power. For each of the contracts at issue, the buyer obtained multiple competing offers, and entered the contract voluntarily because the terms of the contract seemed advantageous at the time. See, *e.g.*, 06-1454 Pet. App. 111a-119a (describing CDWR contract negotiations).

None of this matters under the Ninth Circuit's standard, which permits contracts to be set aside if the market is subsequently deemed to be "dysfunctional." Here, the "dysfunction" took the form of a dramatic increase in prices in the California spot market, which was attributed to (1) unusually high demand for electricity, combined with a scarcity of generation capacity, (2) buyers' excessive reliance on spot-market purchases, due to a confluence of regulatory policies, and (3) illegal manipulation of spot-market prices by other participants in that market. 06-1457 Pet. App. 23a-25a. These were market conditions, however, that affected both buyers and sellers, and that (aside from the illegal actors) neither buyers nor sellers could control.

As applied by the Ninth Circuit here, the standard of market "dysfunction" makes no sense. In a properly functioning market, prices are *supposed to* rise and fall in response to changes in market conditions, including changes in supply and demand, and changes in prices in adjacent markets (whatever the cause). Such price movements indicate that the market is working as it should, not that it is dysfunctional. That is especially true when there is no indication – as there is no indication here – that the contracting parties behaved improperly or that the market was not workably competitive at all times.

The Ninth Circuit undermined the sanctity of contracts in yet another way by allowing – indeed, seemingly requiring – the use of hindsight to determine whether a contract was negotiated in a "dysfunctional" market, rather than relying on the information that was available when the contract was negotiated. That

approach defeats one of the principal functions of contracts. Long-term contracts *always* involve uncertainty about whether market prices will remain at current levels, will increase, or will decline during the term of the contract, and a corresponding risk that the contract price will turn out to be a bad bargain for either the buyer or for the seller, depending on the direction in which market prices move. For both parties, however, the value of certainty over the term of the contract outweighs the concern that it *might* be possible to secure better prices by forgoing certainty and hoping that market prices move in a favorable direction. That certainty will be lost, and the utility of long-term contracts will be greatly diminished, if the contract price can be adjusted later, based on a retrospective determination that the market conditions *perceived by both buyer and seller when they negotiated their contract* were the result of a market dysfunction. Such a judgment inevitably will be biased against the party that secured the benefit of locking in what turn out in hindsight to have been favorable rates. Making matters worse, the Ninth Circuit applies *Mobile-Sierra* asymmetrically. It puts buyers in a "heads I win, tails you lose" situation, in which they can enforce bargains made by sellers even if those bargains were improvident when made or became disadvantageous in hindsight, while sellers cannot enforce the bargains made by buyers, even if they were provident when made, so long as hindsight suggests that a better bargain could have been struck.[6]

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[6] Public Utility District No. 1 of Snohomish County, for example, appears to have bargained aggressively, and struck an extraordinarily good bargain to assure supply during a period of severe energy shortage, by offering Morgan Stanley the inducement of allowing Morgan Stanley to specify the duration of the long-term contract in exchange for agreeing to Snohomish's price and availability demands. See 06-1457 Pet. 4-5. The California Department of Water Resources likewise bragged about its negotiating successes. See 06-1454 Pet. 8-9. *Only* hindsight allows anyone to question the wisdom of entering into these deals, and even in hindsight no one has suggested *any* supplier would have come to respondents' rescue in the way petitioners did had respondents, at that time, demanded in negotiations the terms they now ask regulators to impose.

The Ninth Circuit's new rules dramatically undermine the utility of contracts, at a time when contracts are more important than ever to participants in this industry. Those rules permit buyers to walk away from their commitments even if there has been no market manipulation, unfairness, bad faith, or duress by the seller and no evidence that the seller exercised market power. The buyer need only be able to show, with the benefit of hindsight, that the market was "dysfunctional" when the contract was negotiated, even if the buyer and the seller were equally aware of (or ignorant of) the extent of the dysfunction, and were equally powerless to do anything about it. But this "protection" is available only to buyers, not to sellers.

Regulatory agencies cannot be expected to oppose the assertion that they should have more discretion, rather than less, to judge on a case-by-case basis whether the operation of market forces will adequately protect the public interest, especially if more discretion permits the agency to offer visible, short-term benefits to a discrete group of consumers. The Ninth Circuit evidently concluded that FERC should have more discretion, in order to help the retail customers of these particular buyers. To do so, it had to create new rules that permit FERC to impose rates that it determines to be within a zone of reasonableness, even when sophisticated parties have voluntarily contracted for different rates and waived their rights to seek rate modifications from FERC. The *Mobile-Sierra* doctrine properly recognizes that a casual disregard for the integrity of contracts will, itself, produce market dysfunction. And *that* market dysfunction, which will broadly affect all consumers for an indefinite time, will cause much more harm to consumers, as we explain below. The Ninth Circuit lost sight of this fundamental point.

## III. The Ninth Circuit's New Standards Will Harm Consumers By Impeding The Efficient Operation Of The Wholesale Power Market

The market dysfunction that will arise from the Ninth Circuit's decisions can be prevented only by this Court. If those decisions are not reviewed and corrected, FERC may or may not determine that the rates in these contracts should be reduced. It may read the decisions broadly, to permit or require more aggressive interference with market forces, or narrowly, to uphold the rates in these contracts. But, regardless of how FERC applies the decisions to resolve these particular disputes, the Ninth Circuit's decisions, if uncorrected, will create substantial uncertainty about the extent to which parties can rely on contractual commitments. The risk that contract rates may be modified – if not by FERC as currently constituted, perhaps by FERC when it is controlled by different commissioners; if not these contract rates, perhaps the rates that will be negotiated when prices rise again; if not because of this market "dysfunction," perhaps because of another – is a risk that market participants must reckon with, regardless of FERC's immediate response to the decisions. That risk will remain even if no other court ultimately follows the Ninth Circuit's approach, and even if the Ninth Circuit does not act as drastically in future cases as it has done in these cases. The uncertainty created by having the Ninth Circuit's opinions on the books as valid precedents will *in and of itself* undermine the parties' incentives to enter into mutually and publicly beneficial contracts.

The Ninth Circuit's revisionist interpretation of *Mobile-Sierra* will injure consumers of electric power in several specific ways. *First*, the Ninth Circuit's standards will discourage the use of long-term contracts. Under those standards, the degree of financial risk to sellers will increase in proportion to the duration of the contract. That is because of the risk that, if market prices decline over the duration of the contract, the seller may lose the benefit of the contract price, because the buyer may be able to obtain a reduction in the contract price from FERC under

the Ninth Circuit's standards; but, if market prices rise over the duration of the contract, under *Mobile* and *Sierra* themselves the seller will be locked into the unfavorable contract terms for a long period, and will be unable to obtain contract price modifications. Moreover, if a contract locks in a price for a very short period of time, there will be little opportunity for market prices to move dramatically in either direction, and therefore little financial exposure to the seller as a result of the buyer's "heads I win, tails you lose" advantage. There is a much greater likelihood that market prices might move dramatically, and in an unfavorable direction, over the course of, for example, a ten-year contract, than over the course of a ten-day contract.

The large element of risk that the Ninth Circuit has added to long-term contracts will have many undesirable effects. Long-term contracts play an important role in promoting investment in new productive assets. A power producer considering whether to undertake a major capital investment to increase its generating capacity (or a bank that is considering whether to finance that investment) is more likely to do so if it can secure long-term contracts to sell power at a price that would ensure an adequate return on its investment. Indeed, petitioner Sempra invested *more than $1 billion* in new generating capacity in reliance on a long-term contract that the Ninth Circuit has put at risk. Testimony of Michael R. Niggli, Exh. SER-1 at 37-38, FERC Docket No. EL02-60-003 (filed Oct. 24, 2002). Without the ability to rely on buyers' long-term commitments, potential investors in new generation capacity may be reluctant to risk their capital. See *Mobile*, 350 U.S. at 344 (parties cannot be expected to make "substantial investments * * * without long-term commitments" and such commitments are impossible if "supply contracts are subject to unilateral change"); *Memphis*, 358 U.S. at 113 (Without legal protection of producers' contract rights, "the maintenance and expansion of their systems through equity and debt financing would become most difficult, if not impossible."). Long-term contracts similarly play an important role in facilitating investments by buyers, who may rely on long-term price commitments as insurance that their invest-

ments will be profitable. See *Mobile*, 350 U.S. at 344 (discussing importance of long-term commitment to buyers' investment decisions). They are also an important tool that is used by market participants to hedge against the risk of unfavorable price movements.

Long-term contracts also tend to mitigate market price volatility and, in some situations, the risk of market manipulation. There is no small irony that buyers' excessive reliance on spot-market purchases was one of the causes of the market dysfunction in this case, and that replacing spot-market purchases with purchases under long-term contracts was an important *solution* to that market dysfunction. 06-1457 Pet. App. 24a-25a. The Ninth Circuit's permissive standard for excusing purchasers from their long-term commitments will undermine sellers' incentives to offer long-term contracts, which will again push buyers towards an excessive reliance on short-term purchases.

*Second*, the Ninth Circuit's decisions will discourage the production of more electric power when it is most needed to respond to shortages. The elementary laws of supply and demand teach that shortages lead to higher prices, and severe shortages lead to much higher prices. Sensible policy – policy that serves consumers' best interests – would seek to encourage suppliers to sell more electric power when prices spike upwards, in order to alleviate the shortage and reduce prices. The Ninth Circuit's decisions do just the opposite. Under those decisions, the contractual commitments that sellers can *least* rely on are the commitments that buyers make when market prices have spiked upwards. When market prices are exceptionally high, the likelihood that prices will later decline – leading buyers to seek price reductions through the regulatory process – is at its greatest, and a market characterized by unusually high prices is most likely to be described, retrospectively, as "dysfunctional." When consumers would benefit the most from sellers' agreements to provide more power – when market prices have spiked upwards – the Ninth Circuit's decisions create the greatest disincentive for sellers to enter into such agreements.

The Ninth Circuit's standard makes no sense even if market manipulation caused the spike in prices. If market manipulation has created an artificial shortage, the most effective remedy will be to encourage other market participants to alleviate that shortage by increasing the level of market supply.[7] That response will minimize the harm caused by the manipulation and reduce the wrongdoers' illicit gains, thereby reducing the temptation to engage in market manipulation. The surest means of preventing that desirable response will be to deny benefits (by refusing to enforce their contracts) to those who contract to sell more electricity during periods of market turmoil.

*Third*, the Ninth Circuit's decisions will lead to enormous litigation costs. When the *Mobile-Sierra* doctrine is properly applied, litigation over long-term supply contracts is rare and relatively cheap. The principal issue to be decided is whether the disputed contract is valid. That issue frequently can be decided merely by examining the contract or, in unusual cases, the behavior of those who were involved in negotiating the contract, to determine if they acted deceptively or in bad faith. The Ninth Circuit's decisions will expand both the circumstances in which buyers will be motivated to initiate litigation to escape their contractual commitments, and the scope and likely cost of that

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[7] See Charles Augustine, Joseph Cavicci & Joseph Kalt, *Competition and Regulation, Part III, Tensions Evolve Between Competition and Regulation*, ELECTRIC LIGHT AND POWER (Jan. 2006), available at http://uaelp.pennnet.com/Articles/Article_Display.cfm?Section=ARTCL&ARTICLE_ID=247218&VERSION_NUM=2&p=34 ("[A]s our antitrust principles recognize, if a dominant seller, A, unlawfully exercises market power, its prices can properly be judged to be unjust and/or unreasonable. At the same time, however, these principles recognize that A's exercise of market power will generally pull up the prices of otherwise faultless sellers B, C, D . . . Z, and will induce expansions in those sellers' supplies. In market-driven price regimes, this is desirable: The responses of B, C, D . . . Z dampen the impact of A's conduct and hold overall price levels lower than they would be if these other sellers did not respond. B, C, D . . . Z's prices may be 'high' but B, C, D . . . Z's responses help consumers.").

litigation. Instead of applying well-settled principles of contract law to determine the validity of the contract, the litigation will now address the amorphous question whether the market was "dysfunctional" when the contract was negotiated – a question that may require examination of a wide array of economic and regulatory conditions and the conduct of other market participants. If that inquiry leads to the conclusion that the market was dysfunctional, the litigation must also determine the effects of the market dysfunction, *i.e.*, the amount by which the contract rate exceeds the "just and reasonable" rate. These enhanced litigation costs will be especially burdensome for firms that are principally traders. In this intensely competitive business, profit margins are modest and will be substantially eroded if those contracts that are most favorable to the seller can be enforced, if at all, only by spending large sums on litigation.

*Fourth*, in these respects and others, the Ninth Circuit's decisions will tend to raise the costs and to reduce the financial rewards to companies that produce electric power, and to companies that trade in wholesale power markets. Inevitably the supply of electric power will be reduced and its price driven up.

The decisions will have that effect regardless of the ultimate outcome of the specific disputes involved in these cases. Billions of dollars of contractual commitments are at issue in these cases, but even those billions of dollars are ultimately far less significant than the fact that the Ninth Circuit has severely undermined expectations that contracts will be enforced in all but the most extraordinary circumstances. Sellers in the wholesale power market (and not just the sellers in these particular contracts) will experience the harmful effects of these decisions in the first instance. Far greater harm, however, will arise from the damage that these decisions will inflict on the efficient operation of the market for wholesale electric power, and on the consumers of electric power who are the ultimate beneficiaries of an efficient market.

## CONCLUSION

The petitions for a writ of certiorari should be granted.

Respectfully submitted.

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AUGUST 2007